EMU and the cost of capital

EMU study

HM TREASURY

Executive Summary

1 The third of the UK Government's five economic tests for EMU entry asks whether joining EMU would create better conditions for firms making long-term decisions to invest in the UK. To inform the assessment, this study considers the potential impact of EMU on the cost of capital for UK firms. Economic theory and evidence suggests a firm will invest if the expected returns from the investment exceed the cost of the investment. The cost of capital is therefore an important component of a firm's investment decision.[1]

2 Historically, private sector investment levels in the UK have lagged behind those in other major economies. A possible explanation is that the cost of capital in the UK has been higher than it could be, perhaps due to economic inefficiencies, for example in capital markets, or to instability caused, for example, by mistakes in macroeconomic policy-making in the past. In or out of EMU, the UK Government places a high priority on maintaining macroeconomic stability and on microeconomic reforms aimed at improving the conditions in which UK firms raise capital.

3 Firms' investment decisions are determined by the real cost of capital, which is the nominal cost adjusted for inflation expectations. Firms typically raise capital through either debt or equity. In either case, the cost of capital can be broken down into two key components: the economy-wide credit risk-free rate of return and a market risk premium. There is the potential for both of these components to fall if the UK joined EMU:

- the **credit risk-free rate** may fall if joining EMU reduces macroeconomic volatility and lowers inflation expectations. This was an important economic benefit of EMU for many of the current euro area countries, particularly those with histories of high and volatile inflation; and
- the **market risk premium** component of the cost of capital could fall as the integration of EMU financial markets has the potential to reduce risk for investors in financial assets such as equities and bonds.

Implications of EMU for the credit risk-free rate

4 The credit risk-free rate for major industrial countries which have sustainable debt-to-GDP levels can be proxied by the yields on government bonds. This reflects the virtually credit risk-free status of government debt in these circumstances.

5 Analysis of trends in government bond yields suggests that in euro area countries such as Spain and Italy, where inflation expectations have historically been relatively high, there was a significant decline in nominal credit risk-free rates in the run up to EMU. Nominal risk-free rates in these countries converged to those of low inflation countries such as Germany and France, largely driven by falling inflation expectations. There is no evidence that credit risk-free rates fell in large low-inflation countries in the run-up to EMU as a consequence of prospective membership.

6 The expectation that EMU would deliver a more stable macroeconomic environment may also have reduced the inflation risk premium, and therefore the real cost of capital, in previously high inflation countries. However, the inflation risk premium is unlikely to be an important influence on UK real interest rates given that the market expects the UK macroeconomic framework to maintain stable and low inflation. This is in contrast to the situation in 1997, when UK credit risk-free rates were higher than those of countries such as Germany due to the UK's history of high and volatile inflation.

[1] The analysis in this study of developments in EMU financial markets also provides information that is relevant to the EMU test on financial services, which asks what impact would entry into EMU have on the UK's financial services industry.

7 While the gap between the UK and euro area credit risk-free rates is no longer as large as it was in 1997, there would still be some implications for UK credit risk-free rates were the UK to enter EMU, because this may reduce market segmentation between the UK and euro area government bond markets. This would be driven by the elimination of currency risk between the two markets, and the shared official short-term interest rates in the UK and the euro area. Given this, if all other things were equal, the UK government bond yield curve in EMU would be likely to closely match those of other large AAA-rated government bond markets such as Germany, France and the Netherlands.

8 The move to closer convergence with euro area bond yield curves may involve two shifts. Long-duration UK government yields may rise to euro area levels, while short-duration yields may move down to match lower short-term euro area yields. However, these movements are unlikely to have a significant impact on the real corporate cost of capital. Short-term differences in the euro and UK yield curve probably reflect predominantly cyclical factors, although joining EMU would remove any premium or discount linked to expected changes in the exchange rate. Corporate bond yields at the long end of the curve tend to be dominated by credit risk, limiting the impact of an increase in long UK risk-free rates on the corporate cost of capital. Overall, this means UK entry is unlikely to have a significant impact on the real corporate cost of capital through changes in the credit risk-free rate.

Implications of EMU entry for the market risk premium

9 The second component of the real cost of capital is the market risk premium. Several statistical studies and surveys of market participants have concluded that the euro area financial market has become more integrated since EMU. This has the potential to lower the cost of capital for euro area firms, as the euro area market risk premium could be lower than domestic market risk premia.

10 The market risk premium is composed of credit risk – the risk of default – and of liquidity risk – the risk of not finding a seller or buyer at a reasonable price. The credit and liquidity risks for corporates raising capital in the larger EMU financial market could be expected to be lower than in the smaller UK market. Credit risk may be lower as investors are able to spread risk by investing in a diversified portfolio of assets across a large market. A larger market will reduce liquidity risk as buying and selling assets becomes easier.

11 There is evidence of growth and integration in the euro area financial market since the start of EMU. Euro area corporate bond issuance grew strongly after 1999. Euro area equity issuance also grew up to 2000, tailing off with the fall in global equity markets. There have been changes in the financial infrastructure in Europe, with mergers between stock exchanges, the establishment of pan-European bond trading platforms, and mergers of settlement systems. There is evidence of greater portfolio diversification and a fall in transactions costs within the euro area, suggesting that the integration necessary for a fall in the market premium is taking place.

12 Increased access to the large and integrated euro area financial market could affect the size of the risk and liquidity premia on the UK cost of capital. At present large UK firms can access the euro market from outside EMU at relatively low cost. However, the removal of exchange rate risk and transactions costs that EMU would bring, alongside the removal of some institutional constraints on foreign currency holdings, would increase access at the margin.

13 For UK borrowers to gain the full advantages of lower financing costs from a single European financial market there will need to be significant progress on lowering the remaining legal, regulatory and cultural barriers to full integration. These include the retention of regulations restricting the holdings of foreign assets by pension funds and other investment funds, higher transactions costs involved in cross border activity due to the lack of fully-integrated financial infrastructure and the informational costs still faced by fund managers investing overseas. Removal of these barriers will benefit borrowers whether or not the UK enters EMU.

Implications of EMU entry for SME financing

14 The impact of EMU entry on the cost of capital for small and medium-sized enterprises (SMEs) could be very different from that experienced by larger firms. In principle, the removal of currency costs on cross-border financial transactions would be relatively more important for SMEs. However, information and monitoring costs are also an important reason why SMEs tend to raise funds through local retail finance. Bank lending is the largest source of SME finance in the UK, with over 60 per cent of the total. Venture capital is much less important in volume terms, accounting for just 1 per cent of external financing used by SMEs, but it can be an important source of finance in high-risk and high-growth areas.

15 In EMU, smaller SMEs in particular would be likely to remain reliant on local retail finance. Over the longer term, EMU entry could potentially increase competition in the UK retail market for bank lending to SMEs. It could also increase the size of the venture capital market.

Implications of EMU entry for the structure of corporate financing

16 UK firms are typically characterised as having a different capital structure from those in the euro area: ownership is equity-orientated and highly diversified. Large UK firms rely more on equity to raise capital, while in the euro area bank lending is more important. Some analysts suggest the UK's structure leads to capital market imperfections which raise the cost of capital, though evidence on this is far from clear.

17 Many indicators suggest the euro area is moving more towards an equity-orientated structure. If EMU and other financial developments promote the development of a more equity-orientated finance structure in the euro area, then EMU entry would be unlikely to alter the structure of UK corporate finance. If different ownership structures continue to exist side by side in EMU, and they are augmented by lower barriers to cross border incorporation, this could enable UK firms to utilise different financing structures inside EMU, were the UK to decide to join.

Conclusions

18 Overall, the study finds little scope for UK credit risk-free rates to fall significantly were the UK to enter EMU. The market risk premium for corporate borrowers raising capital in the larger EMU financial market could be expected to be lower than in the smaller UK market. UK firms can access the euro financial market from outside EMU at relatively low cost, but entry would increase access at the margin. These issues are considered in the assessment of the investment test – the third of the Government's tests for EMU entry.